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Date:
May 04, 2015

Legend

Taxpayer =

Corp 1 =

Corp 2 =

Corp 3 =

State 1 =

State 2 =

State 3 =

Project =

Tax Years =

Dear :

This letter responds to a request for a ruling dated November 14, 2014, submitted on behalf of Taxpayer by your authorized representatives. Taxpayer

requested a ruling that payments received by Taxpayer for certain electric transmission system upgrades are contributions in aid of construction under § 118(b) of the Internal Revenue Code. The relevant facts as represented in your submission are set forth below.

Taxpayer, a State 1 corporation, is an electric utility primarily engaged in the transmission and distribution of electric energy in State 1. Corp 1, a State 3 limited liability company, is a regional transmission organization authorized by the Federal Energy Regulatory Commission (FERC) to coordinate the movement of electricity over the electric transmission system serving several states (Corp 1 Control Area). Corp 1 manages all interconnections of generators, merchant transmission facilities, and other utility transmission systems connecting with the Corp 1 Control Area, including the transmission interconnections of the Project with Taxpayer.

Corp 2, a State 3 limited liability company, developed, permitted, financed, built, owns, and operates the Project. Corp 3 is an independent system operator that is authorized by FERC to coordinate the movement of electricity over the electric transmission system serving State 2 (Corp 3 Control Area).

The Project establishes a connection between the regional transmission grids administered by Corp 1 and Corp 3. The Project's State 1 connection interties to an electric transmission system owned and operated by Taxpayer (Taxpayer's System). In order to establish the intertie between the Project and Taxpayer's System, Corp 1 required Taxpayer to construct transmission interconnection facilities and other upgrades to its system (Upgrades). Pursuant to agreements among Corp 1, Taxpayer, and Corp 2, Corp 2 was liable for reimbursing Taxpayer for the costs of the Upgrades. Procedurally, Taxpayer billed the costs of constructing the Upgrades to Corp 1 and Corp 1 billed Corp 2 on Taxpayer's behalf.

Taxpayer received reimbursement payments from Corp 2 for the construction of the Upgrades in the Tax Years. In each applicable tax year, Taxpayer reported the payments as taxable income on its Federal tax returns.

Pursuant to FERC rate-making policy, Taxpayer does not include the cost of the Upgrades in its rate base. Taxpayer wishes to pursue an order from FERC pursuant to Section 206 of the Federal Power Act requiring the interconnecting entity, namely Corp 2, to reimburse Taxpayer for income taxes attributable to the Upgrade reimbursement payments.

Taxpayer requests a ruling that the payments Taxpayer received for the costs of constructing the Upgrades are contributions in aid of construction (CIACs) under § 118(b).

Section 61 and § 1.61-1 of the Income Tax Regulations provide that gross income means all income from whatever source derived, unless excluded by law.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

Section 118(b) provides that the term "contribution to the capital of the taxpayer" does not include any contribution in aid of construction or any other contribution as a customer or potential customer.

Section 1.118-1 of the Income Tax Regulations provides that in the case of a corporation, § 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to a corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production.

The legislative history of section 118 provides, in part, as follows:

> This [section 118] in effect places in the Code the court decisions on the subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.

S. Rep. No. 1622, 83rd Cong., 2d Sess. 18-19 (1954).

In Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), the Court held that payments by prospective customers to an electric utility company to cover the cost of extending the utility's facilities to their homes were part of the price of service rather than contributions to capital. The case concerned customer's payments to a utility company for the estimated cost of constructing service facilities (primary power lines)

that the utility company otherwise was not obligated to provide. The customers intended no contribution to the company's capital.

Later, in Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950), the Court held that money and property contributions by community groups to induce a shoe company to locate or expand its factory operations in the contributing communities were nonshareholder contributions to capital. The Court reasoned that when the motivation of the contributors is to benefit the community at large and the contributors do not anticipate any direct benefit from their contributions, the contributions are nonshareholder contributions to capital. Id. at 591.

Finally, in United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401, 413 (1973), the Court, in determining whether a taxpayer was entitled to depreciate the cost of certain facilities that had been funded by the federal government, held that the governmental subsidies were not contributions to the taxpayer's capital. The Court recognized that the holding in Detroit Edison Co. had been qualified by its decision in Brown Shoe Co. The Court in Chicago, Burlington & Quincy Railroad Co. found that the distinguishing characteristic between those two cases was the differing purpose motivating the respective transfers. In Brown Shoe Co., the only expectation of the contributors was that such contributions might prove advantageous to the community at large. Thus, in Brown Shoe Co., since the transfers were made with the purpose not of receiving direct services or recompense, but only of obtaining advantage for the general community, the result was a contribution to capital.

The Court in Chicago, Burlington & Quincy Railroad Co. also stated that there were other characteristics of a nonshareholder contribution to capital implicit in Detroit Edison Co. and Brown Shoe Co. From these two cases, the Court distilled some of the characteristics of a nonshareholder contribution to capital under both the 1939 and 1954 Codes. First, the payment must become a permanent part of the transferee's working capital structure. Second, it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. Third, it must be bargained for. Fourth, the asset transferred foreseeably must benefit the transferee in an amount commensurate with its value. Fifth, the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Section 118(b) as it now appears in the Code was added by section 824 of the Tax Reform Act of 1986, Pub. L. No. 99-514 (the Act). The House Ways and Means Committee Report for the Act explains that property, including money, is a CIAC (rather than a capital contribution) if it is transferred to provide or encourage the provision of services to or for the benefit of the person transferring the property. H.R. Rep. No. 426, 99th Cong., 1st Sess. 644 (1985), 1986-3 (Vol. 2) C.B. 644. A utility has received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services; if the receipt of the property results in the provision of services earlier than would have been the case had the property not been

received; or if the receipt of the property otherwise causes the transferor to be favored in any way. Id.

The payments received by Taxpayer were a prerequisite to the provision of services and caused Corp 2, the transferor, to be favored. Taxpayer concludes that the payments for the Upgrades are CIACs under § 118(b). Additionally, Taxpayer represents that the Upgrades are compensation for Upgrade construction services provided for Corp 2 and do not satisfy all of the required characteristics in Chicago, Burlington & Quincy Railroad Co.

Accordingly, we rule that the payments Taxpayer received for the costs of constructing the Upgrades are CIACs under § 118(b) and are not contributions to the capital of Taxpayer under § 118(a).

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc: